# Strong Asian Intraregional Trade and Investment Improve Economic Resilience

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I would like to speak on Northeast Asian issues by way of illustrating with examples and while summarizing the content of our annual report, the "Asian Economic Integration Report".

Before I enter into that content, I shall highlight five basic points. The first is that it has been explained that through more than 60% of the economic growth for the global economy as a whole being growth in Asia, the Asia-Pacific region can undoubtedly be called the locomotive of the global economy. The growth in Asia's trade has been strong and steady in the last year or two, and is supporting global economic growth. Asian trade relations have the characteristic of the linkages between countries within Asia being extremely strong.

For the second point, due to the activity in intraregional transactions in Asia, the cross-border financial transactions of the Asia-Pacific region with non-Asian, and in particular with developed nations, are numerous and their global share large.

We have gathered a lot of data and systematically created indexes regarding such intraregional economic and non-economic integration. We have called this the Asia-Pacific Regional Cooperation and Integration Index, and as the third point, the aforementioned two points are backed up by these systematic data.

Last year it was 20 years since the Asian financial crisis, and in our report we have looked at how Asia's financial resilience has changed over the last 20 years, and as the fourth point, what stood out is that there are still a number of challenges in the area of finance in the Asian region as a whole.

In Asia there are the short-term challenges of how short-term financial problems, changes in economic growth, and changes in trade will develop, but taking a little more medium to long-term view, Asia has a massive demand for infrastructure investment. There is the problem that growth will slow down if that demand for infrastructure investment cannot be met, and there is the challenge of how to meet that infrastructure demand. Here we have the fifth point of the great necessity of meeting infrastructure demand via public–private partnerships (PPPs).

I would like to report on these five points in three sections.

In the first section, using the data I would like to look at the current situation and future prospects for the regional integration of the Asia-Pacific region as a whole and of Northeast Asia. In his address, Professor Petri said that regional integration will be important as a strategy to overcome an inward-looking orientation and protectionist tendencies. I believe it is important to look at the current situation and future prospects for the regional integration of the Asia-Pacific region and of Northeast Asia from that perspective.

The second section looks back at the 20 years after the Asian economic crisis, and mentions how the Asia-Pacific region's financial transaction relations and resilience in financial terms have changed, and what challenges there are in the current situation.

In the third section, as medium to long-term challenges I would like to talk about the necessity of meeting the massive infrastructure investment in order to continue Asia's growth, and the great importance of PPPs to that end.

First, focusing on economic integration, I shall compare the figures within the Asian region for 2001 and 2016. For example, trade relations in goods and services from Asia to Asia increased somewhat from 53% in 2001 to 57% in 2016. Direct investment rose from 45% to 55%. It can be seen that the relative density within the region is extremely high. Looking at the relative density within the region in the area of finance, while equity investment has increased from 12% to 19% and bond investment from 8% to 15%, their levels are low. The majority of financial transactions are undertaken between Asia and areas outside the region. The relative densities within the region of migration and remittances are to some extent high, but have fallen, and there is a trend of migration out of Asia and of remittances coming from outside Asia.

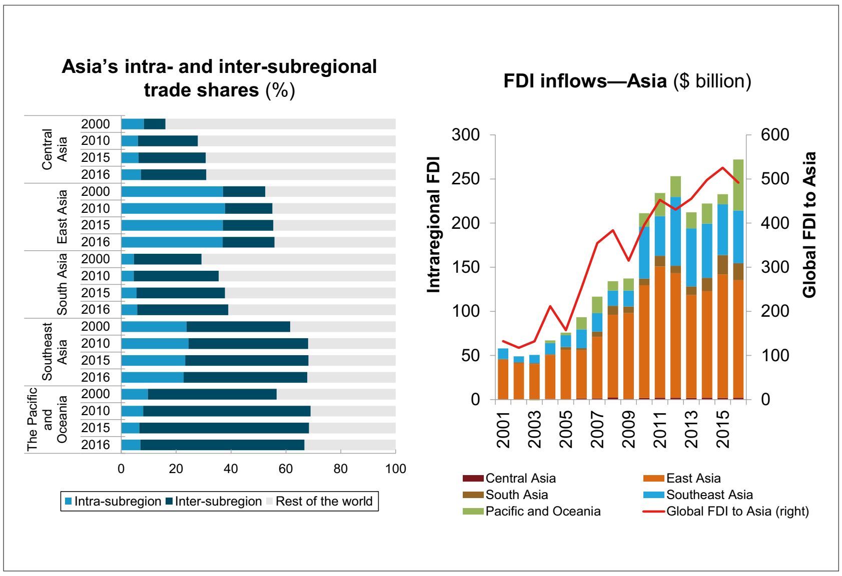
Asia's trade has greatly increased in the last couple of years. As a backdrop to this, the economic performance of developed nations became rather good. In particular, with the strong economic climate in the Eurozone, Japan, and the United States, trade from Asia also increased in reflection of that, and Asia has become a factor supporting the global economy.

The left-hand side of Figure 1 shows the intraregional and extra-regional shares of Asia's total trade. Even looking at subregions such as Central Asia and South Asia, intraregional trade shares have been rising. Conversely, the trade with areas outside the region has been on a falling trend regardless of the subregion.

The right-hand side of Figure 1 shows foreign direct investment (FDI) inflows into Asia. The trend has continued of FDI flowing into Asia from the world as a whole, or in other words, Asia is attracting the direct investment of firms. In addition, a trend of FDI also increasing from within Asia to other Asian countries can be seen.

Meanwhile, Asia's outward debt investment has increased greatly, and, more than being invested within Asia, there is a trend for capital created within Asia and its savings to flow out of Asia. There is a similar trend for equity investment too, and the investment share

Figure 1　Intraregional Trade and Investment Linkages Deepen




Source : Asian Economic Integration Report 2017 within Asia of total investment has been on a decreasing trend in recent years.

The vitality of Asia's economic growth lies if anything in its trade linkages evolving within the region in particular. In order to advance such intraregional trade all the more, two steps will be necessary. One is that, with a process for each country to make trade more open being necessary, the further development of intraregional economic integration and trade linkages beyond that will become necessary. Regarding the former, it will be important to lower obstacles to trade and investment. Regarding the latter, it will be important to approximate a variety of institutions within the region and to deepen institutional regional integration linkages.

Next, via the Asia-Pacific economic integration indexes, I will present the respective integration indexes for the Asia-Pacific region as a whole and the subregions, including Northeast Asia.

For economic integration and regional integration it is possible to capture their shape from a variety of dimensions, but here I have captured economic integration in six dimensions. First: trade and direct investment. The second dimension: money and finance. Third: regional value chains. For example, various components of smart phones are made in various countries, and with creating intermediate inputs in assembling those components, trade linkages do not pass through one industry from upstream to downstream and one country, but trade linkages evolve like a mesh via extremely complex linkages called supply-chain networks. How much are such value chains progressing in intraregional integration?

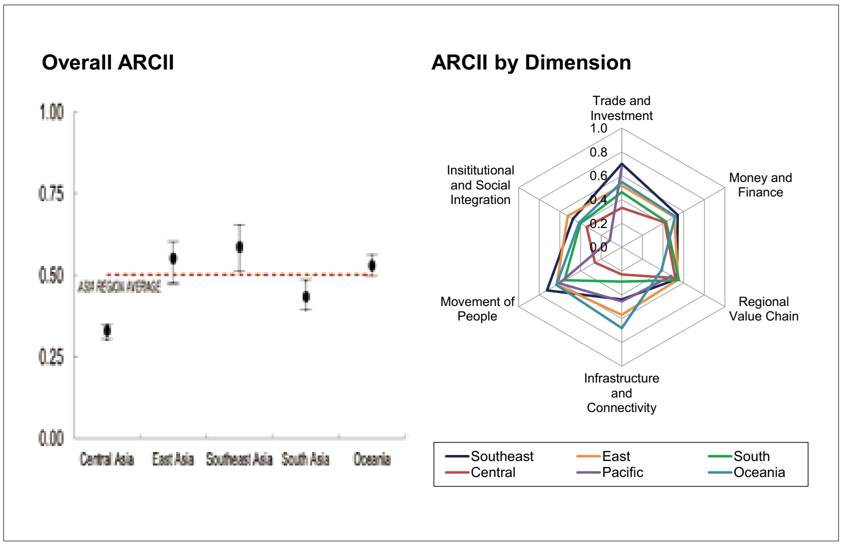
Fourth: how much infrastructure is progressing beyond a country's borders. Fifth: how much regional integration is progressing in the dimension of the movement of people. Sixth: how much institutional and social regional integration is progressing. Through combining various data for these six dimensions, I quantify values and with the data show the shape of regional integration (Figure 2).

The left-hand side shows the overall regional integration index by subregion, constructed by combining 26 data points for the six dimensions. Regional integration is progressing for Southeast Asia as a whole, and in second place is East Asia. Following behind are Oceania, then South Asia, and the most behind in regional integration is Central Asia. Looking at the six dimensions on the right-hand side, integration for Southeast Asia in trade and investment and the movement of people have advanced considerably. As a whole the balance for East Asia is good, but the degree of integration has stalled at a relatively low level. East Asia contains the nations and regions of China, Hong Kong, Japan, the ROK, and Mongolia, but making a slight adjustment by adding Russia in, the results are of the same order.

Next, how do things look in every sub-category (Figure 3)? For trade and investment, regional integration in Southeast Asia has advanced greatly, and in comparison Northeast Asia is lagging behind. For the value chain also Southeast Asia is relatively high, and Northeast Asia is also relatively good, but in terms of level is not very high. For the movement of people, Southeast Asia is high, and Northeast Asia is slightly lagging behind. Looking at financial integration, Northeast Asia is the highest, and Southeast Asia follows behind, but the degree of integration of Asia as a whole is low. Conversely, even in Northeast Asia, the wealth generated is not being invested within the region, and it can be said that it is flowing out of the region. In infrastructure connectivity, Oceania, New Zealand and Australia are moving ahead, and Northeast Asia comes next. Then in institutional and social integration (including whether there are trade agreements and investment agreements, embassies, and a similarity in language), it can be seen that Northeast Asia has relatively strong connections.

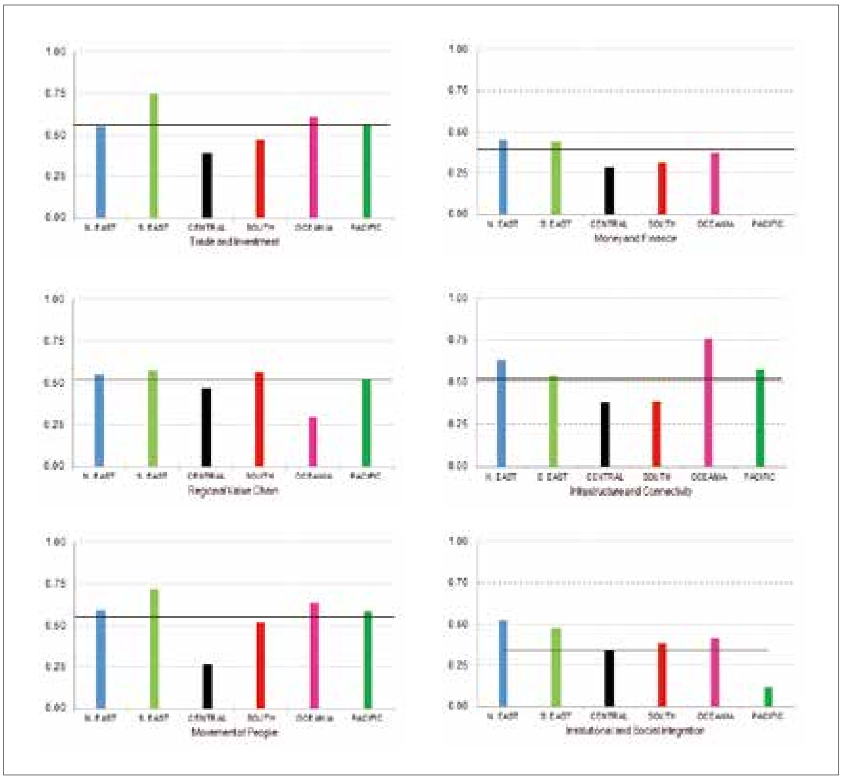
A little more objectively, in order to gauge the degree of integration for Asia as a whole, comparing Asia with other regions, in the overall integration indexes, the EU is highest by far, Asia follows it, and then Latin America and Africa. By dimension, the EU has the highest degree of integration for practically all dimensions, but for trade and investment Asia is slightly higher that the EU. However, Asia is lagging behind in the other dimensions, and in particular, is slightly behind Latin America in infrastructure connectivity and slightly behind Africa in finance.

Figure 2　Asia-Pacific Regional Cooperation and Integration Index (ARCII)




Source : Asian Economic Integration Report 2017

Figure 3　Integration by Subregion



Source : Asian Economic Integration Report 2017

For the second section, I would like to talk on three points regarding the twenty years after the Asian financial crisis. First, for Asia as a whole, in finance terms the structural weaknesses and new challenges stand out. The second point is that there are various institutional policy gaps, and there is the possibility of that leading to financial vulnerability. Based on those, the third point is that it is necessary for Asia's policymakers to conduct financial reforms from a strongly cautious standpoint.

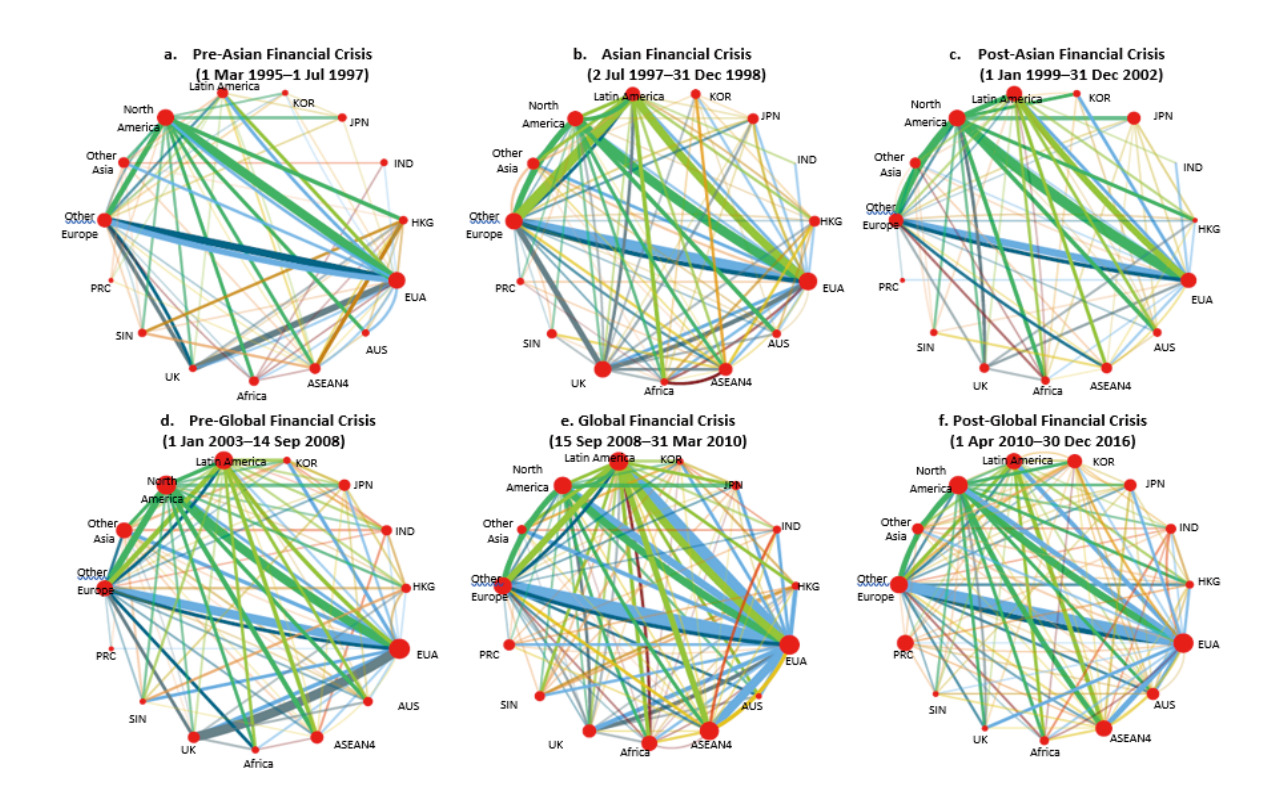
Concerning the first structural weakness, looking at in what form corporate investment will be procured in Asia's emerging economies as a whole, bank finance is the largest, followed by equities, and then debt. Another dimension is that the share of dollar-denominated borrowing in Asia is considerably high, and there is discussion that it was one of the problems of the Asian financial crisis, but the situation hasn't changed even after twenty years. Borrowing in dollar terms and borrowing from banks are two mismatching problems which are still seen extensively in Asia.

In addition, there has been the coming into sharp relief of new challenges. Looking at Asia's private-sector debt (corporate debt and household debt) as a proportion of GDP, in China the share of corporate debt is extremely high, and is on a rising trend. For the ROK, private household debt is extremely large. Very recently the share of China's corporate debt within GDP has been 166%, and the ROK's household debt has exceeded 90%. Malaysia and Thailand are following a pattern similar to the ROK. Borrowing money is not of itself a problem, but what becomes problematic is becoming unable to repay borrowed money. The non-performing loan rate, dividing the total for non-performing loans by the total amount of loans has tended to go down after the Asian financial crisis, and looking at the most recent figures, an increasing tendency can be seen in such countries as China, India, Bangladesh, Indonesia, and Mongolia.

Three challenges are conceivable from such matters. The first is that Asia's intraregional financial connections, in a weak state, are connecting up globally, and intraregional financial integration is not advancing very much. Hasn't this been the situation for the past 20 years? The second is that linking up with the finance of developed countries actually has the potential for increasing parts of Asia's emerging economies feeling the repercussions of various risks in developed countries. The third is that a tendency for the non-performing loan rate to increase is slightly discernable, and it is necessary for macrofinancial policy to also consider such a risk, and to adopt prudent policies.

Regarding these three challenges, I would like to present what can be discerned from a little more detailed data. First are network diagrams (Figure 4) which looked, via financial markets, at the state of increasing links between Asian finance and areas outside the region. Using diagrams derived from observed data showing to what degree financial transactions are deepening among various countries and regions, I have divided them into six periods of time. The upper-left Pre-Asian Financial Crisis was not very dense, but during the upper-middle Asian Financial Crisis the financial transactions among nations and regions deepened. Likewise during the lower-middle Global Financial Crisis, it can be seen that when the crisis occurred, cross-border financial transactions became active. Overall, financial transactions with areas outside the region over the past 20 years deepened greatly.

Figure 4 Connections between Asian Financial Markets and the World




Source : Asian Economic Integration Report 2017

Regarding the second challenge of whether risks emerging in developed countries have repercussions for developing nations, at the time of the 2008 global financial crisis, it was analyzed that the outflow of capital from emerging economies progressed to the extent that those countries borrowed from overseas banks.

The third challenge of what impact the non-performing loan rate would have on macrofinance as a whole was also analyzed using the data. When non-performing loans increased 3.5 percentage points, credit decreased by approximately 4%. Naturally, with their strength weakening banks cannot lend money, and that has a negative impact on the macroeconomy. When the non-performing loan rate increases by 3.5 percentage points, the unemployment rate increases by 0.2 percentage points, and GDP falls by 0.4 percentage points. It can be confirmed that it has a negative impact on the real economy, surpassing the financial markets.

From such a situation several policy pointers can be obtained. First, macroprudential policy (securing stability emphasizing understanding of the risks for the financial system as a whole) will be more important. Second, in order to overcome the problem of a double mismatch in borrowing on a dollar basis from banks, it is necessary to increase bond market transactions in the local currency in the medium to long term. Third, with financial connections within and without the region increasing, it is necessary to consider robust financial regulations aimed at the spillover effects of financial risks from overseas. Fourth, there is the Chiang Mai Initiative within the Asian region, but it is necessary to properly consider a financial safety net for within the entire region.

The third section regards the promoting of the TPP becoming key as a medium to long-term challenge. Asia has achieved smooth growth, and in April 2017 we released an economic outlook for Asia with a 5.7% growth rate, but subsequently the performance was better that initially forecast, and we raised it to 6.0%. In order to sustain this growth, massive infrastructure investment will be necessary. In order to continue the momentum of Asia's growth, maintain the trend of the reduction of poverty, as well as meet the global commitments of the Paris Agreement, including climate change amelioration policies and adaptation methods, infrastructure investment is extremely important. Last year, we issued an estimated figure of US$26 trillion of investment being necessary over the next 15 years. Adjusted annually, that makes US$1.7 trillion. If infrastructure investment of US$1.7 trillion is not made in the Asia-Pacific region as a whole, growth will slow, and it will become impossible to effectively tackle climate change. That is US$1.7 trillion for the Asia-Pacific region as a whole, but for East Asia as a whole, not including Russia, nearly US$1 trillion of investment will be necessary per year. Comparing this US$1.7 trillion with the current actual amount of investment, then approximately US$500–800 billion of investment is lacking. How to increase this and how to procure funding will be a challenge. If the gap isn't closed, Asia's growth will slow, global growth will also slow, and it will not be possible to tackle climate change. Within the US$1.7 trillion, approximately US$1 trillion will be necessary for the energy sector, US$600 billion for the transportation sector, and for the remainder massive infrastructure investment in the energy and transportation areas of the information and communications technology (ICT) sector and the water and sanitation sector.

The methods for procuring the US$500–800 billion lacking in the current situation for investment, have to be divided broadly into two. One is to increase public-sector infrastructure investment, and the other is to increase private-sector infrastructure investment. How best to increase public-sector infrastructure investment? Each country must carry out fiscal and taxation reform. They broaden the fiscal leeway by constricting expenditure and increasing revenue, and utilize the increased room for public infrastructure investment. However, according to our estimations, the expansion of fiscal leeway has its limits, and can only procure approximately 40% of what is lacking. For the remaining 60%, it will be necessary to somehow attract private-sector funding.

In this way, approximately US$300–600 billion of annual private-sector investment must be directed to Asian infrastructure. Consequently public–private partnerships (PPPs) come center stage. Looking at the number of actual PPP projects, they have greatly increased in the Asian region in the last quarter of a century. In particular there are many East Asian PPPs, and in the past decade or so those in South Asia have been increasing. On the other hand Southeast Asia has not increased much, and conversely, it is believed there is potential for PPPs in Southeast Asia. By sector, as expected, PPPs in the energy and transportation sectors have actually been taking place.

For Asia the growth rate is extremely high, and there is the potential to develop highly profitable infrastructure projects, and bankable projects which were also in Mr. Watanabe's address. Speaking of how to bring in private-sector finance, institutional investment assets, such as pension funds, are enormous in developed countries. There are all kinds of figures, but it is said there are some US$70–100 trillion of assets. Developed countries have zero or minus interest rates, and are searching for highly profitable investment opportunities. Given this situation, it can be said that bringing global assets to Asian infrastructure endowed with the potential to be highly profitable will be a major key to filling Asia's infrastructure gap.

Asia's infrastructure projects are potentially highly profitable, but at the same time the risks are also high. With there being high risks, in actuality the funding won't flow in. How to alleviate the risk of funding not flowing in? It will be important to attract developed nation finance and private-sector finance by skillfully incorporating schemes such as credit enhancement and credit guarantees into infrastructure projects.

International financial institutions including the ADB and the World Bank are also directly providing long-term low-interest finance to infrastructure projects in developing nations and emerging economies. However, looking at the absolute amounts, international financial institutions' infrastructure finance is only around 2.5% of that for the entire Asia-Pacific region. Naturally, direct financing is important, but the important role of international financial institutions is considered to be the easy circulation of private-sector funds to Asian infrastructure, via providing an institutional framework resembling credit enhancement.

PPPs are effective methods to attract private-sector funding but are not a panacea. From the data for PPP projects to date it is possible to analyze statistically for what reason PPPs have succeeded or failed. Over the last 25 years, PPPs in Asia of US$41.6 billion were once committed to but were ultimately cancelled as projects. This is equivalent to 6.3% of all PPPs. What is different between the 6.3% failed projects and the 93% that succeeded? The results of the statistical analysis are divided into four main factors.

First is the factor concerning the quality of the projects themselves. In particular, the transparency in their attainment has played a major role in the success of PPPs. In addition, there are mechanisms for reducing risks, but in particular, whether there are schemes resembling credit enhancement in which international institutions are involved has been a key to success. Second, whether the institutional environment is in order, and in particular whether the recipient country has an independent PPP unit, when executing the PPPs, is strongly involved in the success of PPPs. Third, in the macroeconomic environment, such matters as the country having a high growth rate and the country's overall debt as a proportion of GDP being kept under control lead to the success of PPPs. Fourth, in a broader environment, such things as whether the legal system is in order, integration is being properly pursued, and corruption is being kept under control are also key to the success of PPPs.

Finally I would like to raise three points.

First, Asia's integration is advancing especially well in trade and direct investment, but there is room for improvement in financial integration, and in particular when talking about Northeast Asia the integration of infrastructure, and institutional and social integration.

Second, regarding whether financial resilience has increased 20 years after the Asian financial crisis, dollar-denominated bank loans are still extremely large and the so-called double mismatch problem potentially exists. There are many financial transactions between the region and areas outside, and in particular it appears that the risk is also increasing of spillover from financial shocks originating in developed countries. Mechanisms to nip such matters in the bud will also be needed in the future.

Third, in the medium to long-term perspective, considering Asia's growth and the tackling of climate change, infrastructure investment will be extremely important. However, in the current situation it has not been possible to procure infrastructure investment adequately. In the future also, a variety of mechanisms to attract private-sector financing will be necessary. PPPs are such, and international institutions will also play an important role in attracting private-sector funds to Asia.

[Translated by ERINA]